## Brazil's Challenge of U.S. Cotton Program at the WTO

# What's at Stake?

Brazil is alleging that subsidies paid to U.S. farmers growing cotton from 1999 to 2002, and those mandated through 2007 in the 2002 Farm Bill, violate World Trade Organization (WTO) rules. Brazil argues that these subsidies have driven world cotton prices down and caused harm to Brazilian farmers, while significantly increasing the U.S. share of the global cotton market.

Central to the legal challenge are direct payments to U.S. farms under the 1996 and 2002 farm bills, as well as payments made under emergency supplemental appropriations bills. These payments cover so-called producer flexibility payments, market loss assistance payments, and counter-cyclical payments. The U.S. government argues that direct payments are de-coupled—meaning that under the WTO Agreement on Agriculture (AoA), they are not linked to current production, and thus not trade distorting. "Distortion" of trade is caused by any policy or practice that prevents a good or service from being traded at the lowest average annual price on a per country basis.

The WTO Dispute Resolution Body is expected to issue an interim decision on April 26. Interim WTO decisions are only released to the immediate parties of a WTO dispute, while final panel decisions are eventually made public. Final panel decisions typically differ little from interim decisions, and are generally released within 60 days of interim decisions. The April 26 interim decision will determine whether U.S. de-coupled payments provide an incentive for production, and thus are trade-distorting. If the dispute resolution panel agrees with Brazil, then the case will move forward to consider whether Brazilian farmers have been harmed by such payments. The first part of the dispute depends on interpreting the Agreement on Agriculture rules, while the second stage, should it get there, will be based on the Agreement on Subsidies and Countervailing Measures. It is very likely that the ruling will be appealed, no matter what the decision is.

### Levels of U.S. Cotton Support Payments

Under the AoA, domestic subsidies that encourage production are not to exceed 1992 per country levels. According to U.S. Department of Agriculture (USDA) Farm Service Agency, 1992 government payments to cotton producers were $1.62 billion. The USDA Farm Service Agency reports that 1999 government payments for cotton were $2.3 billion, $1.57 billion for 2000 and $2.06 billion for 2001. Data for 2002 and 2003 is not yet publicly available. See details at: fsa.usda.gov/pas/publications/facts/upcot03.pdf

But the issue of which government programs count as subsidies is not simple and has been a source of contention throughout the Brazil-U.S. cotton dispute. The U.S. Trade Representative has resisted in turning over raw data on U.S. subsidies for cotton farmers to the WTO Dispute Resolution Panel, arguing that many of the payments are de-coupled and thus not relevant to the case. In March, the U.S. finally turned over the data, but it has yet to be made public.

### The U.S. Response on Direct Payments

The U.S. argues that direct payments are de-coupled, and should not be counted when compared to 1992 levels of support. Under the WTO Agreement on Agriculture, only domestic subsidies that are categorized as encouraging production are not to exceed 1992 levels. When de-coupled payments are removed, the U.S. is well below 1992 levels of support.

Both direct payments and counter-cyclical payments are made to U.S. cotton farmers based on average acreage and yields from previous years. Farmers have the option of planting certain other crops (besides cotton), or no crops at all, and can still be eligible for government payments based on previous plantings of cotton. Consequently, the U.S. argues that these payments are not encouraging production for the year when the payments are made. But Brazil says that, regardless of whether payments are related to past acreage and planting, the real-world effect is to encourage production.

The U.S. contends that its subsidies, insofar as they are decoupled, are protected under the so-called "Peace

Clause" in the WTO's Agreement on Agriculture. The Peace Clause calls for WTO members to exercise "due restraint" in challenging agriculture subsidies at the WTO as long as countries are below 1992 levels of support. Although the Peace Clause technically expired on December 31, 2003—it is still applicable to the years of cotton subsidy use that Brazil is challenging—1999-2002. The U.S. further argues in a March 3 filing (WT/DS267) that Brazil's invocation of a "cost of production" principle to determine whether or not payments are decoupled "finds no support in the text of the Peace Clause or of any WTO agreement."

For more on the Peace Clause, go to: tradeobservatory.org/library/uploadedfiles/Why_The_Peace_Clause_Must_End_2.pdf

### Does Step 2 Program Act as an Export Subsidy for Transnational Corporations?

Brazil is also challenging a provision of the U.S. cotton program called the Upland Cotton User Marketing Certificate program—or Step 2. First established in the 1990 Farm Bill, the "Step 2" program has paid $1.68 billion over the past eight years to 285 cotton exporters and millers, according to research by the Environmental Working Group. Step 2 pays American companies that export or mill (i.e. process into fabric or yarn) cotton, the difference between more expensive U.S. cotton and cheaper cotton available on the world market, to ensure that U.S. cotton is not disadvantaged despite its cost. "Step 2" payments have been highly concentrated amongst only a dozen companies (4 percent of total recipients), each of which collected at least $35 million and together accounted for half the total payments, or $843.9 million. See more details at: ewg.org/farm/step2cotton.php

Brazil is charging that the program acts essentially as an export subsidy by paying U.S. exporters to buy U.S. cotton and export it onto the world market at prices below the costs of production. The U.S. argues that Step 2 payments do not serve as export subsidies because they are not contingent on "export performance." It is only paid to companies when the lowest US cotton price exceeds the lowest foreign price for a time period of four weeks. The program funds are limited, and in any given year, they may only be used for domestic consumption, rather than exports.

### Brazilian Farmers Hurt by U.S. Cotton Policy

With upland cotton prices declining over the 4-year period from 1998 through 2001, U.S. production increased from 14 million metric tons in marketing year 1998 to a record 20.3 million metric tons in marketing year 2001. The volume of US exports of upland cotton increased significantly from 946.000 metric tons in marketing year 1998 to 1.829.000 metric tons in marketing year 2001. The U.S. share of the world cotton market increased from 24 percent in 1996 to 37 percent in 2001. The International Cotton Advisory Council projects that for 2003/2004, the U.S. share of world cotton exports will reach 42 percent, the highest since 1960/61.

Brazil estimates losses due to U.S. cotton programs are well in excess of $600 million for marketing year 2001 alone including lost revenue, lost production, losses of related services, lost federal and state revenue, higher unemployment and losses in Brazil's trade balance.

Under Article 6.3 d of the Agreement on Subsidies and Countervailing Measures (ASCM), subsidies are judged to have harmed trading partners if the subsidizing member increases its share of the world market when compared to its average share over the previous three-year period.

The U.S. government has not begun to challenge Brazil's claims with regard to the ASCM, because it believes the first part of Brazil's case—that U.S. payments exceed 1992 levels and are trade distorting—is false.

### How Has the U.S. Cotton Program Affected the Global Market?

The export dumping of U.S. cotton at below cost of production prices onto the global market has driven world prices down significantly. In 1990, the U.S. export price per pound for cotton was 71 cents. In 2002, it had sunk to 37 cents. In 2002, the latest statistics available, U.S. companies exported cotton at 61 percent less than cost of production prices, according to the Institute for Agriculture and Trade Policy.

The impact of dumping of cotton onto international markets has been significant. According to the International Cotton Advisory Committee, global cotton prices have fallen to their lowest level in three decades, causing exporting countries combined losses of $14 billion in 2001-2002. The accumulated losses over the last four harvests reach $34 billion.

The plunge in the global price for cotton has particularly hit hard cotton-dependent West African countries like Benin, Mali, Burkina Faso, Chad, and Togo. In 2001, the price fell 19% — costing West Africa some $190 million in lost foreign exchange earnings, calculates Oxfam. When prices fall, export earnings fall, worsening these countries' balance of payments position, weakening their fiscal capacity, generating less revenue for investment in their development, and contributing to their debt overhang.

### What Causes Cotton Dumping?

In the case of cotton and other U.S. grown export commodities, market failures cause dumping.

One factor in market failures is a non-competitive

## Table: U.S. Cotton

| Year | Farmer Production Costs (US$/pound) | Income Support Payment Rate (US$/pound) | Transportation & Handling Costs (US$/pound) | Full Cost (US$/pound) | Export Price (US$/pound) | Percent of Export Dumping |
|---|---|---|---|---|---|---|
| 1990 | 0.8424 | N/A | 0.10 | 0.9396 | 0.7125 | 24% |
| 1991 | 0.7602 | N/A | 0.10 | 0.8574 | 0.6969 | 19% |
| 1992 | 0.7507 | N/A | 0.10 | 0.8479 | 0.539 | 36% |
| 1993 | 0.8024 | N/A | 0.10 | 0.8996 | 0.5536 | 38% |
| 1994 | 0.7057 | N/A | 0.10 | 0.8029 | 0.7324 | 9% |
| 1995 | 1.0341 | N/A | 0.10 | 1.1313 | 0.9344 | 17% |
| 1996 | 0.8477 | N/A | 0.10 | 0.9449 | 0.7793 | 18% |
| 1997 | 0.7461 | N/A | 0.10 | 0.8432 | 0.6962 | 17% |
| 1998 | 0.9608 | N/A | 0.10 | 1.0579 | 0.6704 | 37% |
| 1999 | 0.8357 | N/A | 0.10 | 0.9329 | 0.523 | 44% |
| 2000 | 0.9098 | N/A | 0.10 | 1.0070 | 0.5747 | 43% |
| 2001 | 0.8342 | N/A | 0.10 | 0.9313 | 0.3968 | 57% |
| 2002 | 0.8616 | N/A | 0.10 | 0.9588 | 0.3701 | 61% |

This table shows the calculation of the percent of export dumping for cotton. The government support cost and the cost of transportation and handling are added to the farmer production cost to calculate the full cost of production. The percent of export dumping is the difference between the full cost of production and the export price, divided by the full cost of production. From: *United States Dumping on World Agricultural Markets,* Institute for Agriculture and Trade Policy, 2004.

marketplace. Currently, an increasingly concentrated number of transnational agribusiness firms dominate nearly all agricultural commodity purchasing, transportation and processing, which stifles competition in the marketplace. In 2003, there were 475 cotton-trading organizations around the world. Nineteen of those organizations handled 38 percent of world production, according the International Cotton Advisory Committee (ICAC). The world's three largest cotton trading companies, Allenberg Cotton, Cargill Cotton, and Dunavant Enterprises, are all U.S.-based and are growing rapidly. Seven of the top nine largest cotton companies worldwide are from the U.S., the ICAC reports.

Another critical factor in dumping is over-production. In the past, there were tools, such as grain reserves and set aside programs, designed to help farmers control supply and maintain some degree of market power. These controls helped ensure that prices did not sink below the cost of production. But most of those tools were stripped away under the 1996 Farm Bill. Today, there is significant over-production in cotton, and no limit to how low prices can drop.

With little competition in the market and no controls on supply, prices have sunk well below the cost of production. When prices are low, farmers often produce more to make up in volume of sales what they cannot get in price and to increase the direct payments received on the basis of historical acreage planted to cotton. If they are driven out of business by low prices and too high costs, their land is bought up by larger farms, and in many cases, production actually increases.

### Are Subsidies Causing U.S. Cotton Dumping?

While subsidies are often cited as the cause of agricultural dumping, subsidies are actually a response to market failure, specifically prices below the cost of production. Much of U.S. cotton subsidies are a symptom of a market gone wrong—they rise as prices fall. But subsidies do not dictate price. Remarkably, U.S. cotton subsidies still do not cover costs. According to USDA, in 2000 farmers lost 15 cents per pound, even after government payments, and in 2001 they lost 22 cents a pound after government payments.

Other factors have a more powerful influence over price than subsidies. For example, U.S. soybean prices are currently rising to over $10 a bushel, and prices for corn, wheat and cotton have all risen. Consequently, subsidies paid to U.S. farmers will decline in 2004. The reason for the higher prices is linked to supply levels—weather and crop disease have reduced U.S. and world soybean supplies, and to a lesser extent corn, causing a ripple effect with other crops. The subsidy program has not changed, but supply levels have—and that is what has impacted prices.

Dr. Daryl Ray, of the Agricultural Policy Center at the University of Tennessee, studied what would happen if subsidies for the five biggest U.S. crops, cotton, corn, soybeans, wheat and rice—were eliminated. He found that if the three primary forms of government subsidies—marketing loan payments, counter-cyclical payments, and direct payments—were eliminated, the price of cotton would increase 12 percent—still not enough to make up the difference in current dumping levels of over 60 percent.

Instead, Dr. Ray proposed another approach that combines three policy tools: acreage diversion; food stock management; and price supports. Ray's model shows this approach would immediately increase cotton prices to 50 cents per pound, rising to 64 cents per pound by 2011. If U.S. agricultural policy were to replace crop acreage set asides with the production of bio-energy-dedicated crops, the price of cotton could increase to 73 cents per pound by 2011.

For more on Dr. Ray's analysis, go to: agpolicy.org/blueprint

### Why Are U.S. Farm Programs So Harshly Criticized Around the World?

At the WTO, the U.S. has aggressively pushed countries to reduce their domestic support programs for farmers, to "allow the market to work." Yet, U.S. support programs for farmers have not just continued, but in many cases have dramatically increased since the inception of the WTO. This hypocrisy, exemplified in the 2002 Farm Bill, has enraged countries around the world. At the WTO Ministerial in Cancún, developing countries stood against U.S. negotiating proposals designed to continue U.S. farm programs and to increase market access for dumped U.S. agricultural exports. The developing countries refused to allow negotiations to move forward until the issues of agricultural dumping, market access and domestic support were addressed. The Bush Administration's refusal to respond to this concern is in large part the reason for the stalled WTO and Free Trade Area of the Americas negotiations on agriculture.

### What Impact Could the Brazil Case Have on Other U.S. Farm Programs?

A successful case for Brazil could open the door for additional WTO challenges of U.S. farm programs. If the WTO determines that U.S. direct payments are not de-coupled, and serve as an incentive for production, then direct payments in soybean, corn, wheat and rice programs theoretically could be challenged. While challenges against these types of payments have previously been protected under the Peace Clause, that protection ends this year. Brazil has previously talked of challenging the U.S. soybean program. Ultimately, significant portions of the U.S. farm program may have to be overhauled. ●

Contact: Ben Lilliston
blilliston@iatp.org

## How Should We Address Low Prices?

Low prices in agriculture are the result of structural overproduction, the lack of farmers' market power in negotiating a fair price for their production and the lack of enforcement against agricultural export dumping. Low prices hurt farmers and agricultural dumping hurt farmers in the U.S. and around the world. A positive outcome of the Brazil challenge at the WTO would be a reexamination of agricultural policy, with improving commodity prices for farmers as its central goal. To reach this goal, there are three major components:

▶ **Balancing Supply and Demand:** Governments must introduce supply management programs that are common in other economic sectors. When General Motors has too large a stock of cars on hand, it can shut down a production line until demand increases: without government intervention, individual farmers cannot effectively reduce overall supply. In the U.S., these programs would help lift domestic prices up to at least the cost of production. Because of dramatic increases in global trade and because of planned expansion of agricultural production in larger developing countries and economies in transition, it is time to consider global supply management compacts similar to agreements that have existed in the past for coffee and other commodities.

▶ **Enforce International Law:** the General Agreement on Tariffs and Trade (GATT), now overseen by the WTO, prohibits dumping. However, the rules make it complicated, in practice, for poor countries, to establish grounds for anti-dumping duties because of the requirements to demonstrate harm. Importing countries should have the ability to immediately impose countervailing and anti-dumping duties where goods are sold at below cost of production prices, to bring prices up to cost of production levels.

▶ **Address Market Power of Transnational Corporations:** The largest commodity traders are now vertically integrated to finance trades, process commodities, ship commodities and more. They are the biggest beneficiaries of dumping. They are able to buy inputs and commodities at extremely low prices. Fewer and fewer transnational companies control the global commodity trade. Most major agribusiness firms now have facilities in all the major agricultural exporting and importing countries including the U.S., Brazil, China, Australia and India. There are no provisions in the WTO or other international institutions to address oligopoly market power. A global antitrust system must be put in place to ensure competition in the marketplace.